Accrual Accounting for Military Retirement: Alternative Approaches

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ACCRUAL ACCOUNTING FOR MILITARY RETIREMENT: ALTERNATIVE APPROACHES

Congress of the United States
Congressional Budget Office

PREFACE

The House Armed Services Committee, along with the Administration, has proposed major changes in the way the federal budget accounts for the costs of military retirement. Under the proposals, the budget would reflect costs of retirement benefits being earned by today's military personnel, whereas at present it reflects only the costs of those already retired. This study, prepared at the request of the Defense Subcommittee of the House Committee on Appropriations, describes the proposals, estimates their impact on the federal budget, and cites their important advantages--as well as associated concerns and ways to minimize them.

Although the study makes no recommendations as to the merits of these specific proposals, it is the judgment of the Congressional Budget Office (CBO) that the accounting concepts underlying the proposals are sound and should be implemented. To do so would greatly improve the usefulness of the defense budget by making the full costs of military manpower more visible. It would also assist future debates over changes in military retirement benefits by clarifying long-run cost effects; this should help avoid undue emphasis on near-term economies.

Marvin M. Smith of CBO's National Security and International Affairs Division wrote the study, under the general supervision of Robert F. Hale. The author wishes to acknowledge the technical assistance provided by Toni Hustead, the Department of Defense's Actuary. (Outside assistance implies no responsibility for the final product, which rests solely with CBO.) The study also benefited from earlier analysis by Daniel F. Huck and Edgar A. Peden, formerly of CBO. Helpful assistance was also provided by Earl Armbrust, Alfred Fitt, Robert Hartman, Barbara Hollinshead, Stephanie Martin, and Neil Singer of CBO. Francis Pierce edited the manuscript, assisted by Nancy H. Brooks.

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CONTENTS

		Page
PREFACE		iii
SUMMARY		ix
CHAPTER I.	THE CURRENT ACCOUNTING PROCEDURES FOR MILITARY RETIREMENT AND PROPOSED CHANGES	1
CHAPTER II.	EFFECTS ON BUDGET AUTHORITY AND OUTLAYS OF ALTERNATIVE APPROACHES TO ACCRUAL ACCOUNTING	9
APPENDIX A.	BRIEF DESCRIPTION OF THE CURRENT MILITARY RETIREMENT SYSTEM	19
APPENDIX B.	UNFUNDED LIABILITY AND THE TRUST FUND	21
APPENDIX C.	CHANGES IN ACCOUNT STRUCTURE UNDER 75-YEAR AMORTIZATION OF THE UNFUNDED LIABILITY	23

TABLES

		Page
TABLE 1.	HOW ACCRUAL ACCOUNTING WOULD DIFFER FROM PRESENT BUDGET ACCOUNTING	3
TABLE 2.	CHANGES IN FISCAL YEAR 1985 ACCOUNT STRUCTURE UNDER ACCRUAL ACCOUNTING: HOUSE ARMED SERVICES VERSION BY FUNCTION, AGENCY, AND SUBFUNCTION	11
TABLE 3.	CHANGES IN FISCAL YEAR 1985 ACCOUNT SRUCTURE UNDER ACCRUAL ACCOUNTING: ADMINISTRATION'S PROPOSAL BY FUNCTION, AGENCY, AND SUBFUNCTION	12
TABLE 4.	MILITARY RETIREMENT OUTLAYS, APPROPRIATIONS, NET FLOWS INTO TRUST FUND, AND TRUST FUND BALANCES FOR HOUSE ARMED SERVICES AND ADMINISTRATION PROPOSALS, FISCAL YEARS 1985-1990	16
TABLE C-1.	CHANGES IN FISCAL YEAR 1985 ACCOUNT STRUCTURE UNDER ACCRUAL ACCOUNTING: HOUSE ARMED SERVICES VERSION BY FUNCTION, AGENCY, AND SUBFUNCTION	24
TABLE C-2.	CHANGES IN FISCAL YEAR 1985 ACCOUNT STRUCTURE UNDER ACCRUAL ACCOUNTING: ADMINISTRATION'S PROPOSAL BY FUNCTION, AGENCY, AND SUBFUNCTION	25

SUMMARY

The true costs of military personnel include not only their costs while in service but also their pay after they retire. At a time when the Department of Defense and the Congress are forced by budgetary considerations to make difficult choices in the areas of personnel costs and weapons procurement, it is essential to be aware of the true cost of military personnel in relationship to the cost of other defense resources. Under the federal government's present accounting procedures, the budget includes the cost of benefit payments to service personnel who are already retired and to their survivors. It fails to show the liability taxpayers are incurring for the future retirement costs of military personnel now on active or reserve duty.

The Administration has proposed legislation to remedy this by placing the system on an "accrual" cost basis that would include liabilities as they are incurred. The House Armed Services Committee, in the Defense Authorization Bill for Fiscal Year 1984, has reported legislation similar to the Administration's proposal; if enacted, it would take effect with the fiscal year 1985 budget.

What Accrual Accounting Is

Accrual accounting is a method of recording costs and setting aside funds in current budgets to pay the retirement annuities that eventually will be received by military personnel who are in current service. It would improve military personnel management by making the full cost of manpower more visible, as well as clarifying the full cost of any change in retirement benefits. It would not affect the amount of retirement benefits paid to an employee when he or she retires, nor would it affect the annual outlays paid by the federal government.

Most proposals, including those of the House Armed Services Committee and the Administration, would make the following major changes in the way the budget accounts for retired pay:

- A charge for retirement costs accrued by today's military personnel would be added to the defense function. This "accrual" charge would be the amount actuaries estimate would be necessary to fund the retirement benefits earned each year by today's military personnel. It would reflect expected growth in wages, prices, and interest rates.

- The defense retired pay appropriation would be transferred out of the defense function of the budget and absorbed into the trust fund discussed below. (The retired pay appropriation pays benefits to former military personnel currently on the retired rolls and to their survivors.)

- A military trust fund would be created and shown in the income security function of the budget. The fund would receive the annual accrual charge, a payment for retirement liabilities built up before the fund's existence, and interest on the trust fund balance. This trust fund would also pay all retirement benefits (both current and future) from the funds it receives.

- A board of actuaries would be created to oversee the fund and to make needed technical calculations.

Advantages and Potential Concerns

Accrual accounting would have many important advantages. It would improve manpower management by ensuring that future retired pay costs are considered during today's force structure decisions. For example, under the present budgeting system, the Administration's proposal to add 180,000 persons to the active-duty military over the next five years would have no effect on nondisability retirement costs in the current defense budget. Under accrual accounting, retirement costs would increase by $1.2 billion, thus making clear the true costs of adding personnel at the time of the decision. Similarly, accrual accounting would ensure that the Administration and the Congress faced the full costs of their pay raise decisions, which have important though long-delayed effects on retirement costs.

Accrual accounting would also aid the Congress in evaluating the long-range budgetary effects of prospective modifications in the retirement system. This should avoid undue emphasis on immediate benefit cuts that offer short-term savings.

A potential concern associated with the accrual approach is its sensitivity to technical assumptions about changes in future prices, wages, and interest rates. Different assumptions about these variables could result in different estimates of current costs, thus increasing or decreasing the defense budget. The establishment of an independent board of actuaries to determine the appropriate economic and actuarial assumptions should, however, prevent manipulation of the defense budget for political purposes through arbitrary changes in the underlying assumptions.

A switch to accrual accounting might also confuse the debate over real defense growth, since the change could affect the size of the defense budget. This concern could be overcome by restating data on past defense budgets in accrual terms.

Because it offers many advantages and no problems that cannot be overcome, accrual accounting has been widely recommended. This Administration has recommended the change, as did its predecessor. Accrual accounting has also been recommended by the General Accounting Office.

Effects on Budget Authority and Outlays

Accrual accounting would mean changes in the relative magnitudes of outlays and budget authority in various parts of the federal budget. The House Armed Services and Administration approaches would generally have similar effects and so are discussed together.

Both approaches would result in a modest decline (in any given year) in the budget authority and outlays of the defense function. The two alternatives would add the accrual charge to both budget authority and outlays in the defense function but move the financing of current retirement benefits out of the defense function into the income security function. Relative to the current accounting method, this would decrease the defense function by $0.6 billion in budget authority and outlays in fiscal year 1985. In addition, the Administration approach would also make a payment for the so-called unfunded liability--the liability built up before implementation of the new system--within the defense function, but the payment would also be offset within that function and so would not affect the total defense budget.

Both approaches would also make changes in other budget functions, including the income security function (where the trust fund would be located and from which, under the House Armed Services Committee approach, appropriations to pay off the unfunded liability would be made) and the offsetting receipts functions (where accounting transactions would occur to avoid double counting).

Outlays in the total federal budget would remain unchanged, since accrual accounting does not affect the size of retirement benefits. On the other hand, overall budget authority would increase once the budget began recognizing future retirement liabilities and the unfunded liability. CBO estimates that budget authority could increase by up to $16.1 billion in fiscal year 1985, depending on the technical assumptions chosen, particularly the period used to amortize the unfunded liability.

CHAPTER I. THE CURRENT ACCOUNTING PROCEDURES FOR MILITARY RETIREMENT AND PROPOSED CHANGES

The present budgeting method for military retirement fails to reflect the liability taxpayers are incurring for the future retirement costs of today's military personnel. Instead, current appropriations for military retirement show only the cost of benefit payments to those already retired or their survivors. 1/ At a time when the Department of Defense and the Congress are forced by budgetary considerations to make difficult choices in the areas of force manning and weapons procurement, knowledge of the true cost of military personnel in relationship to the cost of other defense resources is essential to ensure maximum defense capability and budget efficiency.

In order to measure today's defense costs accurately, the defense budget should reflect the future retirement liabilities being built up each year by those contributing to today's defense effort. The Administration (like some of its predecessors) has proposed legislation to change the accounting method for military retirement to an "accrual" cost basis. Accrual accounting would explicitly recognize in the current budget the future retirement liabilities being built up each year by today's military personnel. A separate legislative proposal contained in the version of the Defense Authorization Bill reported by the House Armed Services Committee for fiscal year 1984 provides for similar accounting modifications. 2/

A switch to accrual accounting would make the defense budget a better measure of the cost of today's defense activity. It would also improve military personnel management by making the full cost of manpower more visible, as well as showing the cost effects of changes in retirement benefits. This chapter analyzes the pros and cons of accrual accounting in general terms. Chapter II shows the accounting changes that would be necessary to implement the proposals of the House Armed Services Committee and the Administration.

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1. For a brief description of the current military retirement system, see Appendix A.

2. At the time this report went to press, the House was debating but had not taken final action on this bill.

What Accrual Accounting Is

Accrual accounting records costs as they are incurred rather than when they are paid. It would mean setting aside in today's military budgets sufficient funds to pay the retirement benefits that current military personnel will eventually receive. 3/ Most proposals would make the following changes in the federal budget's method of accounting for military retirement (see Table 1):

- An "accrual charge" for the future retirement costs of today's military personnel would be added to budget authority and outlays in the defense function; the charge would equal the amount actuaries estimate would fully fund the retirement benefits earned each year by today's military force. 4/

- Payments for those already retired--which are determined mostly by past decisions--would be transferred out of the defense function into the income security function where costs for Civil Service and Social Security retirees are currently recorded.

- Money would be provided to fund over a period of time the liabilities for retirement benefits built up before the implementation of accrual accounting.

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3. Accrual methods are used extensively in business accounting to record costs, revenues, and profits when they actually occur, even though the funds involved may be paid out or received at other dates.

4. More specifically, the annual charge is the amount that must be set aside each year so that the discounted present value of the charges over the entire career of a group of military employees is equal to the discounted present value of retirement benefits that must be paid to those who remain in the service long enough to retire. Thus the calculation considers all employees, not just those who retire, and assumes varying lengths of service. The charge also depends on future inflation, wage growth, and interest rates. It is usually expressed as a level percent of the annual basic payroll. The accrual charge could remain in the defense function (050) or be transferred to another budget function such as income security (600). The underlying principle of accrual accounting would be better served by the transfer. If transferred to the income security function, it would not only be recorded immediately in budget authority of the defense function but also in outlays as well.

TABLE 1. HOW ACCRUAL ACCOUNTING WOULD DIFFER FROM PRESENT BUDGET ACCOUNTING

Budget Function	Budget Authority	Outlays	Explanation of Change
		Current Accounting	
Defense (050)	Payments to those already retired	Payments to those already retired	
		Proposed Accrual Accounting	
Defense (050)	Accrual Charge	Accrual Charge	Outlay entry, which is offset below, ensures that defense function reflects future costs
Defense (050) or General Government (800) a/	Payments for unfunded liability	Payments for unfunded liability	Entry pays off past liabilities
Income Security (600)	Accrual Charge plus unfunded liability		Transfers from 050 and other functions
		Payments to those already retired	
Undistributed Offsetting Receipts (950)	-Accrual Charge	-Accrual Charge	Offsets outlay in 050 and eliminates double counting of budget authority

a. Appropriate offsetting entries would be made in these same functions to offset outlays and eliminate double counting of budget authority.

- A trust fund would be created to receive the accrual charge, the payment on the unfunded liability, and other payments. These funds would be used to pay all retirees (both current and future).

- A board of actuaries would be created to oversee the trust fund and make needed technical calculations.

These changes would only modify accounting procedures. The adoption of accrual accounting would not affect actual pay or benefit levels for military personnel or current retirees. Nor would accrual accounting affect the retirement costs to the federal government.

The key accounting change is the placement of the accrual charge in the defense function, which ensures the visibility of retirement costs in the defense budget. The proposals of the House Armed Services Committee and the Administration would also establish an interest-bearing trust fund, though this is not a key change. The fund would receive the annual accrual charge along with periodic payments to liquidate the retirement liabilities built up prior to the adoption of accrual accounting. While neither a trust fund nor paying off the "unfunded liability" are necessary features of an accrual system, there are good reasons why the Congress might opt for both. A trust fund would bring the military retirement system closer to the system for Civil Service retirement, which has a trust fund. 5/ Moreover, by having a trust fund and paying off the unfunded liability the military system would follow the practice of many private-sector pension plans which are required by law to have actuarially sound accrual systems. The Congress might wish to do this to emphasize the government's role as a model employer. (For more discussion of the trust fund and unfunded liability, see Appendix B.)

Advantages of Accrual Accounting

Accrual accounting would improve manpower management by incorporating future retired pay costs into today's budgetary process and force structure decisions. For example, under the present budgeting system, the

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5. In addition to a trust fund, the Civil Service retirement system is financed through accrual charges in agency budgets. However, unlike the proposed accounting changes in military retirement, the accrual charge in civil service retirement does not fully reflect future wage and price growth, thus understating the appropriate amount of the charge.

Administration's proposal to add 180,000 persons to the military over the next five years would have no affect on nondisability retirement costs as reflected in the defense budget until some of them began retiring--that is, in about 20 years. These costs are likely to be ignored during the planning stage. Under accrual accounting, the addition of 180,000 persons to the military would increase retirement costs in the current defense budget by about $1.2 billion and thus make clear the true cost of adding personnel at the time the decision to increase the size of the military was made.

Much the same is true of pay decisions. Annual decisions about the size of the military pay raise eventually affect retirement costs, especially if--as has sometimes been the case in recent years--larger raises are provided to senior personnel. Under present accounting methods, the full effects of pay raises on retirement costs do not show up for many years. Accrual accounting would ensure that the Administration and the Congress faced the full costs of their pay raise decisions as they made them.

An accrual system might also improve defense decisions involving cost tradeoffs among weapons systems requiring different numbers of active-duty personnel for operation and maintenance. The Navy is currently completing the design of a new destroyer, which will be bought in large numbers, and the Air Force is beginning the design of a new fighter aircraft. These and many other weapons can probably be manned with fewer personnel if special equipment is added, or alternatively can use larger crews and less labor-saving equipment. In estimating life-cycle costs of future weapons, there may be a tendency to understate personnel costs since retirement outlays would not show up in the budget for many years. Under accrual accounting, defense programmers and Congressional committees would have more incentive to recognize retirement costs fully in such weapons decisions.

Another advantage of an accrual system is that revisions in the military retirement plan would immediately be reflected in the size of the accrual charge. This would aid the Congress in evaluating the long-range budgetary effects of prospective modifications in the retirement system. 6/

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6. Accrual accounting as a federal budgeting practice has a long, but unsuccessful, legislative history. The first stirrings of legislative interest in accrual accounting can be traced to the Budget and Accounting Procedures Act of 1950, which required the approach as a prerequisite to approval of agency accounting systems by the Comptroller General. A 1956 amendment to that act (P.L. 84-863) made it mandatory for agency accounts, but the term lacked precise definition

Under current accounting procedures, full costs of changes in future retirement benefits would usually not appear in the current budget. An example can be taken from recent history. In 1980 the Congress decided to base military retirement pay on average pay during the three years when pay was highest, rather than pay at the date of retirement. This "high-three" provision was made applicable, however, only to those entering the military after enactment of the legislation, thus ensuring that nondisability retirement costs would not be affected for almost 20 years. Consequently, the budget showed little immediate change. Had accrual accounting been in effect in 1980, the accrual charge and hence the defense budget would immediately have shown a reduction of about $1.2 billion. In the same way, accrual accounting would make clear the long-range benefit changes considered during any future Congressional debate over military retirement. This would avoid undue emphasis on immediate benefit cuts that offer short-term savings.

Potential Concerns and Ways to Minimize Them

Despite its many important advantages, implementation of accrual accounting raises some potential concerns. Nevertheless, with the proper measures the concerns would be avoided or minimized.

One issue would be what assumptions to use in calculating the accrual charge. The charge is an estimate of the amount that would have to be set aside in a current year to provide all retirement benefits attributable to the current year's service. It is very sensitive to economic and actuarial assumptions about the future course of interest rates, wages, and productivity; future mortality; and rates of disability, retirement, or withdrawal from the system. As an example, lowering the assumed annual real rate of interest from 1.0 percent to 0.5 percent would raise the accrual charge in 1985 by $2.4 billion or 14 percent.

The sensitivity of the accrual charge to differences in technical assumptions inevitably raises questions of the system's integrity and susceptibility to short-run budgetary pressures. These concerns could be allayed by establishing an independent board of actuaries to set and adjust the accrual charges and related calculations after determining the appropriate

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and has never been implemented. For a discussion of accrual accounting's broader implications for federal budgeting, see Congressional Budget Office, "Federal Financial Reporting: Accrual Accounting and the Budget," Technical Analysis Paper (June 1977).

economic and actuarial assumptions. The House Armed Services and Administration approaches both require the appointment of such a board.

During the transition from the current military retirement system to an accrual cost approach, the proposed accounting changes could appear to alter the size of the defense function even if there was no real change in activity. This might lead to confusion over the real rate of defense growth, particularly if a defense budget under the accrual system was compared with a previous one not under accrual accounting. Such difficulties could be avoided by restating the defense budgets for earlier years in terms of the new accounting procedures.

Accrual Accounting Widely Recommended

Because it offers many advantages, and no problems that cannot be avoided or minimized, accrual accounting has been widely recommended. Both this Administration and its predecessor have proposed the change. Accrual accounting has also been recommended by the General Accounting Office and by a commission set up in 1976 to study defense manpower problems. 7/

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7. See Comptroller General of the United States, Need for Overall Policy and Coordinated Management of Federal Retirement Systems, vol. 1 (December 1978), and Defense Manpower Commission, Defense Manpower: The Keystone of National Security (April 1976).

CHAPTER II. EFFECTS ON BUDGET AUTHORITY AND OUTLAYS OF ALTERNATIVE APPROACHES TO ACCRUAL ACCOUNTING

This chapter focuses on the proposals for accrual accounting made by the House Armed Services Committee and the Administration, since these are the most likely to be debated by the Congress. Since the approaches are very similar, they are discussed together. Minor differences are noted during the discussion.

Specific Provisions

The essential step in accrual accounting is to replace the present retired pay appropriation for current retirees in the defense budget with an accrual charge for military retirement. The House Armed Services and the Administration proposals both do this.

They would also liquidate the unfunded liability--that is, the retirement liabilities accumulated for military service performed prior to the implementation of the accrual system--by amortizing it over a specified period of time through annual payments into a trust fund. The trust fund, which would also receive the annual accrual charge, would pay all retirement benefits and earn interest on its balance.

Finally, both options would establish an independent board of actuaries to determine the economic assumptions and actuarial basis of the accrual system. These include projections of inflation, interest rates, and wage growth in addition to actuarial valuations of death, disability, withdrawal, and retirement rates. The board would also determine the period of time over which the system's original unfunded liability would be amortized. The members of the board, who would be appointed by the President for terms of 15 years, would report annually to the Secretary of Defense and periodically to the President and the Congress on the status of the trust fund, and on its accounting assumptions. The board would recommend changes needed to ensure that the trust fund remained actuarially sound.

The House Armed Services and Administration proposals differ significantly in only two ways. The Administration proposal would have accrual accounting begin in fiscal year 1984, the House in 1985. (For simplicity, this

study assumes that both are implemented beginning in 1985, since it seems unlikely that such a complex change can be accomplished by the beginning of 1984.) The Administration proposal would provide annual funds from the defense function to pay off the unfunded liability, whereas the House proposal would finance this out of the general fund of the Treasury. The following discussion of budget effects illustrates the difference.

Budget Effects in Fiscal Year 1985

Key Changes. The most important changes in the system of accounts would occur in the Department of Defense military budget and in the total federal budget. Tables 2 and 3 show how the changes would affect the accounts under the House Armed Services and Administration proposals respectively.

The important changes are reflected in columns 1 and 7 in each table. Column 1 shows the changes that would occur in the Department of Defense's military budget (subfunction 051). Under both proposals, it would no longer include the retired pay appropriation of $17.6 billion. In its place, the Department of Defense would incur an accrual charge of $17.0 billion, for a net reduction of $0.6 billion. Under each proposal, the same change would take place in the total defense function (function 050), which includes not only the military budget but also civil and other defense activities.

The accrual charge of $17.0 billion represents 50.7 percent of the expected 1985 cost for military basic pay. 1/ Actuaries estimate the 50.7 percent using a so-called "entry-age normal method" and specific assumptions about future mortality, interest rates, wage growth, and other variables. 2/

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1. The actuarial costs are expressed as a percentage of basic pay because this is the only pay that all military personnel receive in cash. As a percentage of total pay--which includes other allowances and pays other than basic pay--the percentage would be lower. Thus care should be used when comparing the 50.7 percent to percentages for other private or public pension plans.

2. Actuaries commonly call this the entry-age normal cost. It represents the charge--expressed as a constant percentage of basic pay--that must be set aside each year to fund future retirement annuities that are earned by the military work force in the current year. The long-

Column 7 in each table shows the second important change, namely the change that would result in the total federal budget. Under both proposals, there would be no effect on total outlays, since there would be no change in retirement benefits as a result of the adoption of the accrual system. Total budget authority, however, would increase as the budget began to recognize the system's future retirement liabilities. In 1985, this would equal $16.1 billion for reasons discussed below.

Changes to Set Up Trust Fund. Columns 2 through 6 in each table show the changes from current accounting procedures needed to set up and maintain the military retirement trust fund. Column 2 shows the funds coming into and going out of the trust fund. Under both proposals, the trust fund receives an accrual charge of $17.0 billion in budget authority. But the accrual charge only reflects future retirement liabilities. In order for the system to be actuarially sound, as both the House Armed Services and Administration proposals require, the unfunded liability built up before implementation of accrual accounting must be amortized over a specified period of time. 3/ However, neither proposal specifies the period. If 40-year amortization is assumed (consistent with the requirements for private pension plans set out in the Employee Retirement Income Security Act), then a payment of $15.5 billion in budget authority in fiscal year 1985 would be made into the trust fund. 4/

The House Armed Services bill requires that this payment on the unfunded liability be made from the general fund of the Treasury, shown in

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term economic assumptions used by the DoD actuary in the calculation of the 50.7 percent estimate include increases of 5.5 percent per year, and a nominal interest rate of 6 percent per year. In addition, the 50.7 percent estimate is based upon an actuarial assumption of dynamic improvements in life expectancy.

3. In addition to the pre-existing unfunded liability, new unfunded liabilities or actuarial surpluses may occur after the creation of a trust fund as a result of differences between economic and actuarial assumptions and actual experience. Both the House Armed Services and Administration proposals provide for the amortization of any new unfunded liability along with the pre-existing unfunded liability. In the case of actuarial surpluses, the two approaches would liquidate and transfer them to the general fund of the Treasury.

4. The accounting is the same regardless of the payoff period chosen.

TABLE 2. CHANGES IN FISCAL YEAR 1985 ACCOUNT STRUCTURE UNDER ACCRUAL ACCOUNTING: HOUSE ARMED SERVICES VERSION BY FUNCTION, AGENCY, AND SUBFUNCTION
(40-year amortization, in billions of dollars)

	(1) Defense DoD Military (051)		(2) Income Security DoD Civil: Military Retirement Trust Fund (602)		(3) General Government DoD Civil: Payment for Unfunded Liability (805)		(4) Undistributed Offsetting Receipts Employer Share, Employee Retirement (951)		(5) Interest Treasury: Interest on the Public Debt (901)		(6) Undistributed Offsetting Receipts Interest Received by Trust Funds (902)		(7) Total Budget	
	BA	O a/	BA	O	BA	O	BA	O	BA	O	BA	O	BA	O
Accrual Charge b/	17.0	17.0	17.0	0.0	0.0	0.0	-17.0	-17.0	0.0	0.0	0.0	0.0	17.0	0.0
Unfunded Liabilities														
Appropriation from federal fund to trust fund	0.0	0.0	15.5	0.0	15.5	15.5	0.0	0.0	0.0	0.0	0.0	0.0	31.0	15.5
Offsetting collections	0.0	0.0	0.0	0.0	-15.5	-15.5	0.0	0.0	0.0	0.0	0.0	0.0	-15.5	-15.5
Interest on Trust Fund Balance	0.0	0.0	1.2	0.0	0.0	0.0	0.0	0.0	1.2	1.2	-1.2	-1.2	1.2	0.0
Retired Pay Appropriations	-17.6	-17.6	0.0	17.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-17.6	0.0
Total	-0.6	-0.6	33.7	17.6	0.0	0.0	-17.0	-17.0	1.2	1.2	-1.2	-1.2	16.1	0.0

a. BA is Budget Authority and O is Outlays.

b. Assumes HASC fiscal year 1984 pay raise of 4.0 percent, CBO baseline pay raise of 4.8 percent in fiscal year 1985, and constant fiscal year 1983 end strength.

TABLE 3. CHANGES IN FISCAL YEAR 1985 ACCOUNT STRUCTURE UNDER ACCRUAL ACCOUNTING: ADMINISTRATION'S PROPOSAL BY FUNCTION, AGENCY, AND SUBFUNCTION
(40-year amortization, in billions of dollars)

	(1) Defense DoD Military (051)		(2) Income Security DoD Civil: Military Retirement Trust Fund (602)		(3) Defense DoD Civil: Payment for Unfunded Liability (054)		(4) Undistributed Offsetting Receipts Employer Share, Employee Retirement (951)		(5) Interest Treasury: Interest on the Public Debt (901)		(6) Undistributed Offsetting Receipts Interest Received by Trust Funds (902)		(7) Total Budget	
	BA	O a/	BA	O	BA	O	BA	O	BA	O	BA	O	BA	O
Accrual Charge b/	17.0	17.0	17.0	0.0	0.0	0.0	-17.0	-17.0	0.0	0.0	0.0	0.0	17.0	0.0
Unfunded Liabilities														
Appropriation from federal fund to trust fund	0.0	0.0	15.5	0.0	15.5	15.5	0.0	0.0	0.0	0.0	0.0	0.0	31.0	15.5
Offsetting collections	0.0	0.0	0.0	0.0	-15.5	-15.5	0.0	0.0	0.0	0.0	0.0	0.0	-15.5	-15.5
Interest on Trust Fund Balance	0.0	0.0	1.2	0.0	0.0	0.0	0.0	0.0	1.2	1.2	-1.2	-1.2	1.2	0.0
Retired Pay Appropriations	-17.6	-17.6	0.0	17.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-17.6	0.0
Total	-0.6	-0.6	33.7	17.6	0.0	0.0	-17.0	-17.0	1.2	1.2	-1.2	-1.2	16.1	0.0

a. BA is Budget Authority and O is Outlays.

b. Assumes HASC fiscal year 1984 pay raise of 4.0 percent, CBO baseline pay raise of 4.8 percent in fiscal year 1985, and constant fiscal year 1983 end strength.

column 3 of Table 2 as a payment from subfunction 805. This avoids adding costs to the defense function not related to current defense decisions. Under the Administration proposal, as shown in column 3 of Table 3, the payment on the unfunded liability would be made out of subfunction 054 of the defense function--presumably because it is defense-related--but would also be offset in subfunction 054 to avoid including in the defense function costs related to current defense decisions. Thus, the difference in the placement of the payment on the unfunded liability represents a minor difference that does not affect the total amount in the defense function 050.

In addition to the accrual charge and the payment on the unfunded liability, the trust fund would also receive in budget authority $1.2 billion in interest on the trust fund balance (arising because the $15.5 billion unfunded liability income plus the accrual charge exceed the $17.6 billion in outlays for current retirees). 5/

Changes to Avoid Double Counting. The remaining changes in columns 3 to 6 offset certain of the above transactions to avoid double counting. All changes in outlays are offset, since outlays are not changed in the total budget (see column 7). However, not all of the changes in budget authority are offset. Budget authority initially increases by an amount equal to the funds coming into the trust fund for future retirement liabilities: $17.0 billion for the accrual charge, plus $15.5 billion for payment on the unfunded liability, plus $1.2 billion for interest on the trust fund balance. This increase is partially offset because under accrual accounting--which reflects future liabilities rather than liabilities already incurred--budget authority for the $17.6 billion in payments for those already retired no longer appears in the budget. Current retirees are funded from the accrual and unfunded liability appropriations plus any interest earned. Net budget authority in the overall budget, therefore, increases by $16.1 billion ($17.0 billion plus $15.5 billion plus $1.2 billion less the offset of $17.6 billion). This $16.1 billion becomes the trust fund balance at the end of 1985 and also represents an increase in the federal debt. All of the debt increase would be internal to the federal government, however, so debt held by the public would not be affected.

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5. As noted above, these estimates are based on the assumption of a 40-year payoff period. In the case of a 75-year payoff period, the payment on the unfunded liability would be $8.9 billion instead of $15.5 billion, and interest payments $0.7 billion rather than $1.2 billion (see tables in Appendix C).

Budget Effects Beyond 1985

In the years beyond 1985, accrual accounting still would not change total federal outlays. The effects it would have on budget authority, and on outlays in individual budget functions, depend on the assumptions made concerning the size of the military and the relation of wages, interest rates, and prices in those years. For purposes of illustration, it is assumed here that military end strength remains at the fiscal year 1983 level, interest rates decline from 7.1 percent in 1986 to 6 percent in 1990, and wages increase by 4.8 percent annually. These assumptions are consistent with those used by CBO in its January 1983 five-year projections.

As is reflected in Table 4, implementing accrual accounting under these assumptions would result in continued reductions in budget authority and outlays in the defense function relative to its size under current accounting procedures, since the accrual charge would grow more slowly than the retired pay appropriations it replaced (see second and third columns of Table 4). Also shown in Table 4 is the growing trust fund balance, which would result in increases in total federal budget authority. Ultimately, the trust fund balance would reach a level sufficient to pay total obligations to current and future retirees. Assuming no changes in end strength, retirement benefits, or economic and actuarial assumptions, the trust fund balance would remain at this steady-state level indefinitely.

TABLE 4. MILITARY RETIREMENT OUTLAYS, APPROPRIATIONS, NET FLOWS INTO THE TRUST FUND, AND TRUST FUND BALANCES FOR HOUSE ARMED SERVICES AND ADMINISTRATION PROPOSALS, FISCAL YEARS 1985-1990 (In billions of dollars) a/

Fiscal Year	Retired Pay Outlays b/	Accrual Cost	Payment on the Unfunded Liability	Net Amount Going to Trust Fund c/	Trust Fund Balance (End of Year)
			Unfunded Liability Amortized Over 40 Years		
1985	17.6	17.0	15.5	14.9	16.1
1986	18.8	17.8	16.3	15.3	33.7
1987	19.8	18.6	17.2	16.0	52.9
1988	20.9	19.5	18.1	16.7	73.8
1989	23.1	21.2	19.1	17.2	96.5
1990	24.6	22.5	20.2	18.1	121.5
			Unfunded Liability Amortized Over 75 Years		
1985	17.6	17.0	8.9	8.3	9.0
1986	18.8	17.8	9.4	8.4	18.6
1987	19.8	18.6	9.9	8.7	29.1
1988	20.9	19.5	10.5	9.1	40.5
1989	23.1	21.1	11.0	9.1	52.6
1990	24.6	22.5	11.7	9.6	65.9

a. Appropriations include both the accrual charge and the payment on the unfunded liability.

b. Also represents what retired pay appropriations would be under the current accounting system.

c. Does not include interest on the trust fund.

APPENDIXES

APPENDIX A. BRIEF DESCRIPTION OF THE CURRENT MILITARY RETIREMENT SYSTEM

The current military retirement system consists of three noncontributory components. It pays retirement benefits to military personnel with 20 years or more of active service, to qualifying reservists at age 60, and to qualifying individuals on disability retirement from the military. The system also pays benefits to surviving families of members who elected to forgo part of their annuity in order to have survivor's family benefits.

The basic active-duty nondisability benefit is calculated as 50 percent of basic pay for those with 20 years of service and 2.5 percent for each additional year of service, up to a maximum of 75 percent of basic pay for those with 30 years or more. The basic pay used in the calculation of benefits is equal to final basic pay if the retiree entered the Armed Services before September 8, 1980. For those who entered on or after September 8, 1980, basic pay (for benefit calculation purposes) is equal to the average of the highest 36 months of basic pay. Reservists receive points for portions of years of creditable service for retirement purposes and at the age of 60 can (so long as they have at least 20 years of creditable service) receive a benefit based on this service. Those on disability retirement receive basic pay multiplied by the larger of (1) 2.5 percent times years of service, or (2) the percent of disability (not to exceed 75 percent of base pay).

At the end of fiscal year 1982, over 1 million persons were receiving regular retirement benefits, 133,244 reservist benefits, 142,105 disability benefits, and 77,346 survivor benefits. In fiscal year 1982, system outlays were $14.9 billion. This is expected to rise to $16.4 billion in fiscal year 1983 and $20.9 billion in fiscal year 1988.

APPENDIX B. UNFUNDED LIABILITY AND THE TRUST FUND

The key feature of accrual accounting would be the replacement of the present retired pay appropriation in the defense budget with an accrual charge; this step would achieve the improved visibility of manpower costs. The establishment of a trust fund and the paying off of unfunded liability are not essential to a viable accrual system for military retirement.

However, many proposals to establish accrual accounting for military retirement obligations call for creating a trust fund and amortizing the system's pre-existing unfunded liability, following the example set by private-sector pension plans. In considering their merits, it should be emphasized that the accrual charge is a separate issue from the liquidation of the unfunded liability. It should also be noted that the unfunded liability in private-sector pension plans differs in its importance from a similar liability in a public-sector plan. Fully funded pension plans with funds held in trust offer private-sector employees a measure of protection against benefit losses from adverse economic circumstances or company mismanagement. While such safeguards may be necessary in the private sector, they are not essential in a military retirement system that is backed by the resources of the federal government.

Proponents of a military retirement trust fund also argue that interest earned on invested balances would provide additional funds to defray future retirement obligations. But such earnings would represent only accounting transactions, since the trust fund would invest in federal government securities; interest would take the form of payments from one part of the government to another.

Another point raised in connection with the handling of the unfunded liability is that the failure to liquidate it through amortization would prevent the system from being actuarially sound. While amortization is a requirement for most private-sector pension plans, it would not be essential to accrual accounting for military retirement. Since total outlays for retirement benefits would not be affected under an accrual system, all that would be necessary is that the accrual charge in any given year cover actual retirement outlays. If it failed to do so, the shortfall for that year could be made up by a supplemental appropriation from the general fund of the Treasury, which would be tabulated under the income security function.

APPENDIX C. CHANGES IN ACCOUNT STRUCTURE UNDER 75-YEAR AMORTIZATION OF THE UNFUNDED LIABILITY

TABLE C-1. CHANGES IN FISCAL YEAR 1985 ACCOUNT STRUCTURE UNDER ACCRUAL ACCOUNTING: HOUSE ARMED SERVICES VERSION BY FUNCTION, AGENCY, AND SUBFUNCTION
(75-year amortization, in billions of dollars)

	(1) Defense DoD Military (051)		(2) Income Security DoD Civil: Military Retirement Trust Fund (602)		(3) General Government DoD Civil: Payment for Unfunded Liability (805)		(4) Undistributed Offsetting Receipts Employer Share, Employee Retirement (951)		(5) Interest Treasury: Interest on the Public Debt (901)		(6) Undistributed Offsetting Receipts Interest Received by Trust Funds (902)		(7) Total Budget	
	BA	O a/	BA	O	BA	O	BA	O	BA	O	BA	O	BA	O
Accrual Charge b/	17.0	17.0	17.0	0.0	0.0	0.0	-17.0	-17.0	0.0	0.0	0.0	0.0	17.0	0.0
Unfunded Liabilities														
Appropriation from federal fund to trust fund	0.0	0.0	8.9	0.0	8.9	8.9	0.0	0.0	0.0	0.0	0.0	0.0	17.8	8.9
Offsetting collections	0.0	0.0	0.0	0.0	-8.9	-8.9	0.0	0.0	0.0	0.0	0.0	0.0	-8.9	-8.9
Interest on Trust Fund Balance	0.0	0.0	0.7	0.0	0.0	0.0	0.0	0.0	0.7	0.7	-0.7	-0.7	0.7	0.0
Retired Pay Appropriations	-17.6	-17.6	0.0	17.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-17.6	0.0
Total	-0.6	-0.6	26.6	17.6	0.0	0.0	-17.0	-17.0	0.7	0.7	-0.7	-0.7	9.0	0.0

a. BA is Budget Authority and O is Outlays.

b. Assumes HASC fiscal year 1984 pay raiseof 4.0 percent, CBO baseline pay raise of 4.8 percent in fiscal year 1985, and constant fiscal year 1983 end strength.

TABLE C-2 CHANGES IN FISCAL YEAR 1985 ACCOUNT STRUCTURE UNDER ACCRUAL ACCOUNTING: ADMINISTRATION'S PROPOSAL BY FUNCTION, AGENCY, AND SUBFUNCTION
(75-amortization, in billions of dollars)

	(1) Defense DoD Military (051)		(2) Income Security DoD Civil: Military Retirement Trust Fund (602)		(3) Defense DoD Civil: Payment for Unfunded Liability (054)		(4) Undistributed Offsetting Receipts Employer Share, Employee Retirement (951)		(5) Interest Treasury: Interest on the Public Debt (901)		(6) Undistributed Offsetting Receipts Interest Received by Trust Funds (902)		(7) Total Budget	
	BA	O a/	BA	O	BA	O	BA	O	BA	O	BA	O	BA	O
Accrual Charge b/	17.0	17.0	17.0	0.0	0.0	0.0	-17.0	-17.0	0.0	0.0	0.0	0.0	17.0	0.0
Unfunded Liabilities														
Appropriation from federal fund to trust fund	0.0	0.0	8.9	0.0	8.9	8.9	0.0	0.0	0.0	0.0	0.0	0.0	17.8	8.9
Offsetting collections	0.0	0.0	0.0	0.0	-8.9	-8.9	0.0	0.0	0.0	0.0	0.0	0.0	-8.9	-8.9
Interest on Trust Fund Balance	0.0	0.0	0.7	0.0	0.0	0.0	0.0	0.0	0.7	0.7	-0.7	-0.7	0.7	0.0
Retired Pay Appropriations	-17.6	-17.6	0.0	17.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-17.6	0.0
Total	-0.6	-0.6	26.6	17.6	0.0	0.0	-17.0	-17.0	0.7	0.7	-0.7	-0.7	9.0	0.0

a. BA is Budget Authority and O is Outlays.

b. Assumes HASC fiscal year 1984 pay raise of 4.0 percent, CBO baseline pay raise of 4.8 percent in fiscal year 1985, and constant fiscal year 1983 end strength.

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